RICHARD RUSSELL'S DOW THEORY LETTERS INCORPORATED

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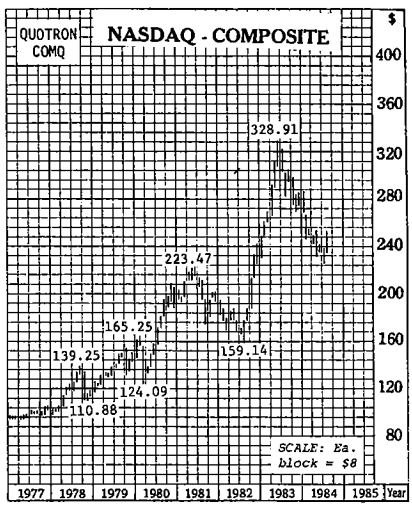
October 17, 1984 **LETTER 898**

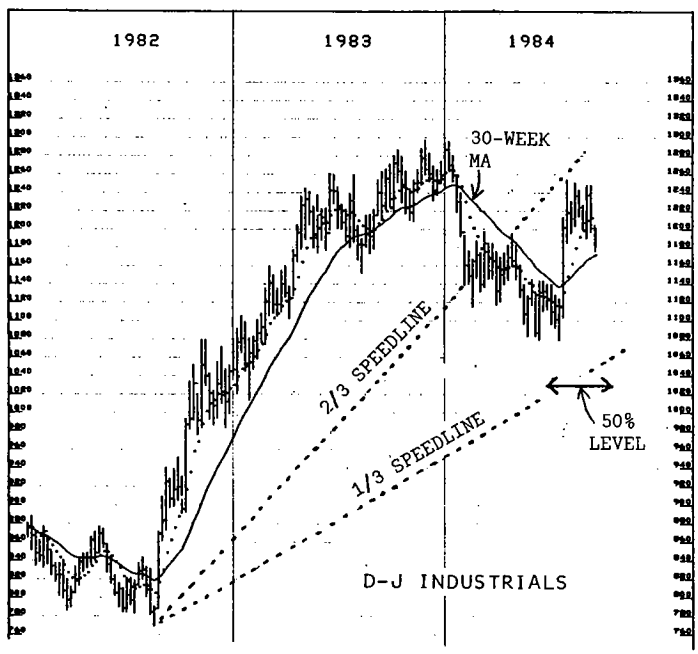
Oct. 5, DJIA 1182.53; PTI 1603; A-D Ratio –20.81
Oct. 11, DJIA 1190.70; PTI 1611; A-D Ratio –20.56

THE MARKET: A few of the items that have been worrying me (they were noted in the last Letter) are still in the balance. From a strict Dow Theory standpoint, the nearby levels of importance in the Averages have been the August-September lows of 1196.11 for Industrials and 506.12 (the September 5 low) for Transports. On October 2 the 1196.11 Industrial low was decisively violated, but the Transport low of 506.12 was much more resistant. As this is written (but see Late Notes on page 6) Transports have held stubbornly above 506.12, so a (bullish) downside non-confirmation is now in force. The longer the Transports hold above the 506.12 level, the better the odds that the market has seen the lows and that the downside action has petered out. Of course, if the Transports do confirm the Industrials by violating 506.12, the *secondary* trend would be considered bearish.

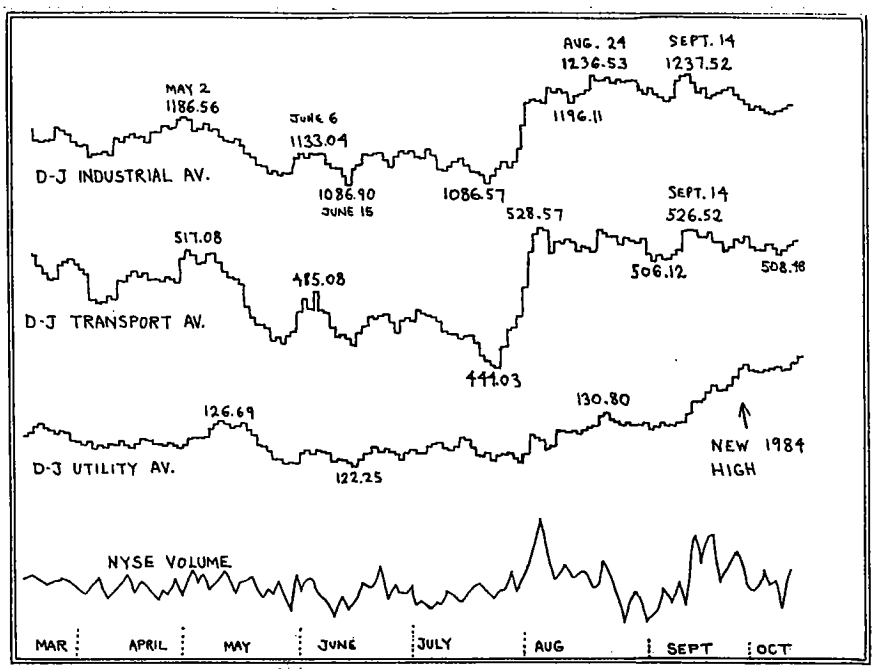


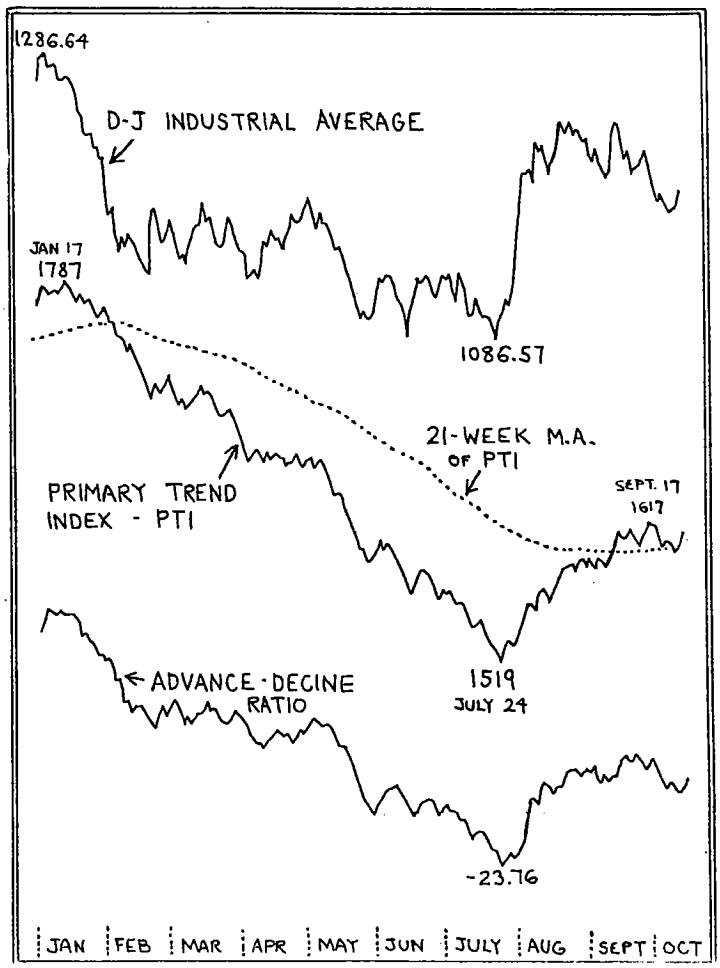
Of *primary* importance are the July lows of 1086.57 for the D-J Industrial Average, 444.03 for the D-J Transportation Average. If those mid-Summer lows are violated, a Dow Theory bear market would be signaled.

There is a well-advertised split in the current market with the Dow doing very much better than the secondary stocks. In fact, some observers have gone so far as to say that the D-J Industrials are in a bull market while the bulk of the NASDAQ issues are in a bear market. Note on this monthly chart (courtesy of Horsey) that the broad NASDAQ Composite of over-the -counter stocks lost roughly 30% of its value during the 1983-84 correction. Furthermore, the recovery in the NASDAQ stocks has been minimal. In contrast, the blue chip stocks have done considerably better, but in my own experience neither the blue chips nor the secondaries will go too far on their own. Ultimately, the entire market tends to move together.



Historically, the primary trend of the stock market (under the Dow Theory) is identified in terms of the action of the D-J Industrial and Transportation Averages. In view of this, I want to re-examine a chart that I published in Letter 896. This weekly chart





(see page 1) presents three tests for the Dow, each one significant and important. The first test is simply the position of the Dow in relation to its own 30-week moving average. As you can see, the MA is now approximately in the 1160-65 range. Currently, the Dow is probing the 1160 level, and any plunge decisively below 1165 would have to be viewed as negative for both the Dow and the market in general.

The second test entails the use of the 1/3 and 2/3 speedlines (these are concepts introduced by the great technician, Edson Gould). The speedlines are based on both time and distance. The Dow (see chart) has already broken below its 2/3 speedline and therefore a test of the 1/3 speedline (now at approximately 1080) cannot be ruled out. At the July low the Dow came down to within 60 points of its 1/3 speedline, but a closer test might still be in the cards.

The third test comes at the 50% level of the entire 1982-1983 rise. That level is 1032. Ten months have now elapsed since the January peak in the Dow, and the 50% level of 1032 still stands inviolate. Thus the Dow is in the bullish mode in relation to the 50% Principle.

The studies provide us with major tests for the Dow over the long term. The first serious breakdown in the Dow would occur if the Dow slipped below 1160-65 level, the level of 30-week moving average. Another serious test would come at 1080– at the 1/3 speedline level. The final and most important test would come at 1032, the 50% level.

I would say without hesitation that the biggest plus in this market is the action of the D-J Utility Average taken together with bonds. Both the Utilities and the D-J Bond Average have been in rising trends, and this is normally a powerful positive force on the market. So far, however, despite the superior action of the Utilities and Bonds, the market has been a sloppy affair (very unusual in the face of the joint rising Utility and Bond markets).

For the benefit of new subscribers, I should say that I attach a great deal of importance to the action of my Primary Trend Index (PTI). The PTI is an amalgam of eight market indicators, and each of these indicators is based on ACTION (rather than sentiment, economic, monetary, etc.). The theory here is that the only trustworthy evidence is based on market action rather than extraneous subjective indicators. And in the end, we "make or break" on the action of the market, not on what the leading indicators say or what the M-1 will be next week.

To recount a little history, the PTI broke above its declining trendline on August 9, thus giving its first bullish reading of 1984. On September 13, the PTI crossed above its 21-week moving average, and this was our major bullish signal and a signal to buy on. The PTI hit a recovery high of 1617 on September 27, and since then the PTI has been doing a tight-rope walk just above the 21-week moving average.

On September 9, the PTI dipped just to the 21-week MA and the next day the indicator edged up again. So the status of the PTI as of this writing is neutral-positive. As I stated in the last Letter, it bothers me that the September highs in the PTI were not confirmed by the Averages, and this could be the technical basis for trouble. But I can't out-guess my own indicator, so I find myself waiting and wondering like everyone else.

INVESTMENT POSITION:

The bull remains in the box because the PTI remains above its 21-week moving average. I would still like the Averages to confirm the PTI by moving back over the highs, but as I've so often said, they don't arrange the stock market for Richard Russell's convenience. The A-D ratio has actually held up better than the Dow, and this is hopeful (as is the strong bond and utility action).

Hold on to your current stock positions, but I will state again that the position I like best and the position I have been advising since July is bonds, high grade bonds. By the way, muni bonds are now yielding from 80% to 90% as much as T-bonds (normally they only yield around 70% as much). Thus, high-grade munis are cheap. You can buy AA-rated munis from your state yielding over 10% which are totally tax free. To me, this is an attractive longer-term vehicle for compounding yourself into riches (the munis, by the way, are cheap because there has been a ton of new issues). Ten grand in 10% munis will net you $26,000 in ten years. And there will have been no taxes to pay. It sure has attracted me.

MARKET THOUGHTS: I've been watching (scrutinizing is a better word for it) the stock market since 1945. That's almost an embarrassingly long time. After 39 years of watching, you'd think I would get tired of it. But I haven't. The truth is that I'm still fascinated by the stock market. It's a never ending, never totally solvable puzzle.

After one works with the market for a decade or more, one tends to develop rules and even a market philosophy. And I've done that. My market rules and philosophy cover a lot of ground, but I'll list a few that may be helpful at this juncture.

(1) I try not to get excited (or obsessed) with the market. When I do, I find it almost always costs me money. The fact is that the major movements and the profitable movements of history give you time–time to get in and time to get out. So my advice is "Take it easy." Excitement in the market will usually raise your blood pressure, not your bank account.

(2) One of the hardest rules to follow is, "Believe the market, not the prevailing sentiment or the prevailing gossip." Today it is harder to follow this rule than ever simply because there is so much so-called "expert advice" floating around. But expert advice never impressed me. The only thing that impresses me is the market action itself.

(3) Never disregard the action of the D-J Industrials and Transports. Next in importance is the advance-decline ratio. If I could read anything perfectly, it would be these three indicators. Theoretically, they can tell you all you need to know about the market.

(4) I never ignore the action of the D-J 20 Bond Average taken together with the D-J Utility Average. When these two Averages move in tandem (together) the market almost always follows. Exceptions to this rule are few and far between.

(5) I don't know why, but many experts still ignore the Dow Theory principle of confirmation. Ignore the confirmation rule at your peril. Movements of the D-J Industrial Average or the D-J Transportation Average alone have little forecasting value. As a matter of fact, when the market wants to fool us, it will set off a spectacular solo movement of one Average (often through a widely watched support or resistance point). Such moves are more often than not–deceptive.

(6) I use TIME in my market analysis, but in a special way. One of my rules is that the longer the Averages fail to do what everyone expects, the better the chance that they are NOT going to do what everyone expects. For instance, if everyone expects the Averages to rush to new highs and weeks and months go by and they don't go to new highs–then believe what is happening. The Averages, in all probabilities, are not going to new highs.

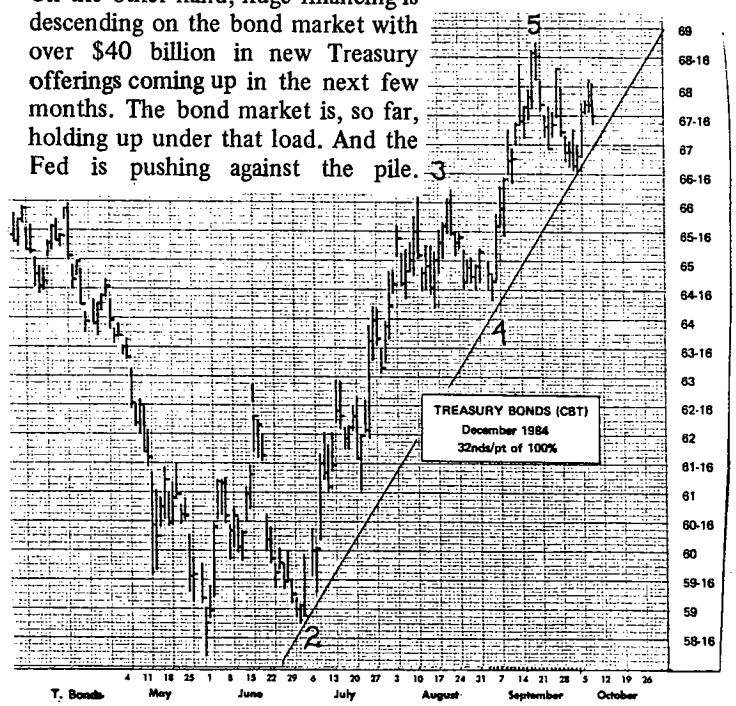
(7) I have a rule that states, "Don't be too cute." A companion rule is "Don't play the part of a market genius." What do I mean? Well, as an example there are those who are now predicting a market crash. Now I don't know, maybe the market will crash, maybe it won't, but crashes are very, very rare occurrences, they are history-making occurrences. To predict one accurately is like throwing dice and coming up with 12 four times in a row. It's possible, but it's a rare occurrence. So I don't try to play market genius. The odds are stacked too high against my being that right.

(8) Every major bull or bear movement usually ends up with confusion in the indicators. At such times, watch the most persistent indicator. When that indicator gives up, you're at the turn. For instance, after a long advance, the averages may look toppy,but the A-D ratio continues to climb. Watch the A-D ratio carefully. When it turns down, the market is going to turn solidly bearish.

(9)This is an important rule: "The market is not always clear and it is not always talking. At such times, don't force the issue. Accept it; you don't know what's going on, neither does anyone else. Relax.

BOND, RATES: Earlier in the year I termed this the most important chart in the nation. It still is. Here we see the daily action of the December Treasury bond contract. I noted in the last Letter that we have a perfect Elliott 1-2-3-4-5 bullish rise. The expectation now would be for a correction through the rising trendline and maybe down to the 66 area.

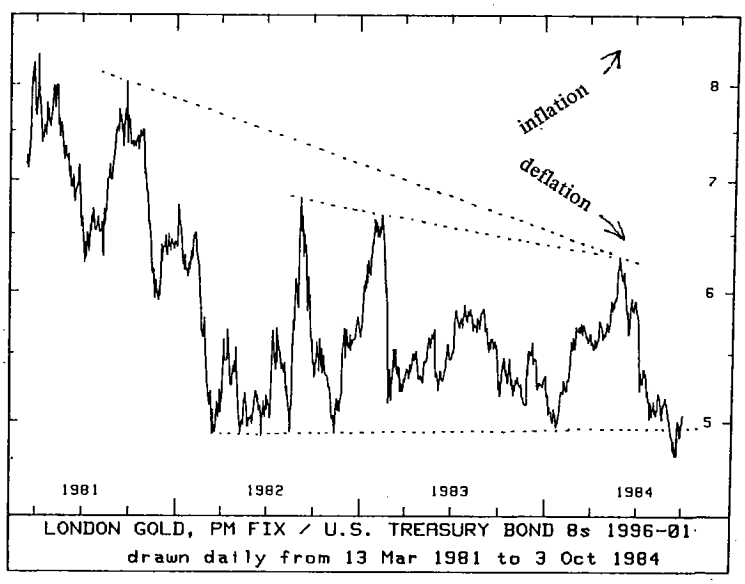
Fundamentally, there's a battle going on here. The Fed is easing up considerably (probably, as expected, trying to bring interest rates down just before the election). On the other hand, huge financing is descending on the bond market with over $40 billion in new Treasury offerings coming up in the next few months. The bond market is, so far, holding up under that load. And the Fed is pushing against the pile.



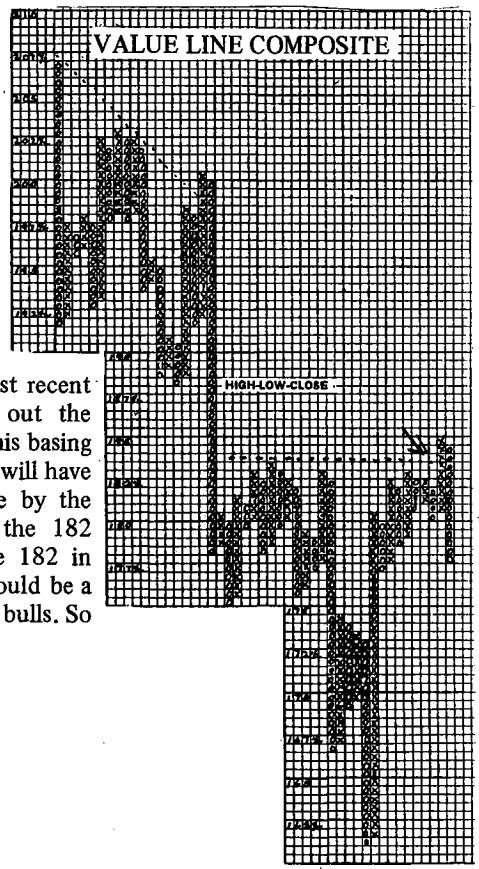
INFLATION? Every name economist in the nation (and there are a lot of them) has a personal theory and a personal prediction regarding inflation. I'm more interested in a single ratio, the ratio of gold to Treasury bonds. Gold tends to rise during inflation, bonds tend to decline during inflation. The ratio of gold to bonds therefore provides us with a very sensitive market-oriented inflation (or deflation) gauge.

When this ratio rises in favor of gold, the market is expecting inflation. When it declines in favor of bonds, the market is expecting no inflation or (heaven forbid), deflation.

The story on this chart (which was kindly prepared by subscriber



John Carder of Los Lunas, NM) is as clear as can be. After two and a half years of indecision, the ratio has broken down in favor of bonds and deflation. However, it will be important to see whether this "downside breakout" is followed through. New lows in the ratio would be strong confirmation that inflation was last year's war.



I've been featuring this Value Line Composite chart because it presents a potential massive market bottoming process. As you can see, we had a break-out. from a huge head-and-shoulders base (arrow), then a recent dive back to the 177 area. This most recent drop does not wipe out the pattern, however. If this basing pattern is to work, we will have to see a new advance by the Value Line through the 182 level. Anything above 182 in the V-L Composite would be a huge breakout for the bulls. So let's see what happens.

NOTES & QUOTES: Old J. Paul Getty was a wily and suspicious character. Or maybe the billionaire founder of Getty Oil didn't trust his heirs. At any rate, Getty left a multi-billion dollar trust and he laid down the rule that trust could only invest in the government securities of the United States, Britain, Canada, Switzerland, Sweden, Norway and Denmark. Did Getty know something we don't know–nobody ever accused J. Paul of being stupid!

Speaking of Getty, the Getty Museum here in California has an endowment now valued at an unbelievable $2.2 billion. US tax law states that the Getty must spend at least 4.5% of its endowment annually, and that currently comes to around $100 million a year. The museum needs less than $9 million a year to operate, so spending the other $91 million is a problem. The Getty Trust now plans to open a $100 million complex in Brentwood on a 750 acre hillside. Getty intends to stay with classic art, rather than modern.

* *

As subscribers know, I'm a read-a-holic. I spent my early reading years reading fiction, but I seldom read fiction today. One reason is that I find biographies more interesting and more instructive than fiction–and actually many biographies read like fiction ("Truth is stranger than...").

I just finished *James Agee, A Life* by Lawrence Bergren, E.P. Dutton, $20 hard cover. It's a fascinating story of a genius who could not leave liquor or women alone. A poet, a screen writer, a writer for Time and Fortune, and the father of serious cinema criticism, Agee amazed all who knew him. He died of a heart attack at the age of 41, destroyed by neuroses, cigarettes, alcohol and a crazy life. A fascinating book.

Last week I saw an exhibit of photos of the Polish ghetto here in Balboa Park in San Diego. Along with many photo books, the Museum of Photography also offered a Random House book of photos entitled *Auschwitz Album* ($23.50 hard cover). At first I didn't have the stomach to buy the book. The next day I went back and bought it. I bought it out of respect to the million that died in Auschwitz. I know there are voices today who claim that the Holocaust never happened. You don't believe it? Try Auschwitz Album.

One more reading item. I love the magazine, *American Heritage*, (PO Box 977, Farmingdale, NY 11737). The price of this $24 magazine is a bargain, compared with what they give you. The current edition (a special on American medicine) was particularly fascinating. Example, in an interview with the former medical director of Johns Hopkins Hospital, Dr. David Rogers notes as follows:

> There's no doubt that we are seeing an awful lot of hand-wringing about our aging population. Some gloomy souls tell us that chronic disabling conditions are going to be ever-increasing and that we are going to have to spend our whole gross national product caring for those eighty and over, who will be largely mindless and infirm. But I do not think there is cause for such despair. As others have pointed out, there's a big misunderstanding here. When we say life expectancy is increasing, we don't mean that we are extending life. In fact, the maximum duration of life for most humans probably has not changed much in a hundred thousand years: it averages somewhere around eighty-five years, maybe eighty-six or eighty-seven. Nothing medicine has done has moved that figure up one bit. What we have done is to protect different groups so that more and more people have a chance of reaching that classic age. And of staying healthy and vigorous almost to the end.
>
> ***Are you saying not only that more people reach old age but also that fewer of them get senile?***
> Percentagewise, yes. What we are shooting for is a system in which we will have the answers to cancer, to the rotting of your arteries, to the aging of your brain, and to other mysteries, so that you have every chance of taking care of yourself and surviving soundly to eighty-five or so, at which point you can just take to your bed one day and be dead shortly thereafter. If this could be accomplished, the care of our elderly would not be such a disproportionate expense to society. And the point is, I believe we are getting closer and closer to that ideal.

* *

It has been said that Chicago Cub fans are everywhere in the US, since over time thousands of people have left Chicago to settle elsewhere, and these Chicago refugees remain die-hard Cubbie fans.But San Diego is different. Thousands of people *come to* San Diego each year, while few people ever leave (and if you spend a few weeks here you'll know why). Thus, San Diego has few fans in the rest of the country, and the Padres were therefore outcasts, unknowns. Furthermore, Ray Kroc, originally a Midwesterner, spent years trying to buy the Cubs, but ended up buying the Padres and moving to La Jolla. Ray, as you know, founded McDonalds and made millions in hamburgers (Ray died last year, and will have to miss his triumph). Detroit Tigers owner Tom Monaghan made his millions in pizza, and the current World Series has therefore been dubbed the "Hamburger-Pizza Wars."

At any rate, the Padres are in the World Series for the first time, and San Diego is still in a state of shock. Furthermore, the Superbowl is due to play here in 1988. The only question is whether our football Chargers will be in it. Ah well, as I've always said, "Win or lose we still have the weather."

Cynicism abounds. A Washington Post cartoon shows two old people sitting in front of a TV set. The TV commentator says, "The Democrats have come out against cutting Social Security." Then he says, "The Republicans have come out against cutting

Social Security." Finally he states, "Each party is trying to outdo the other in saying how they will protect Social Security." The man and his wife look at each other and say, "Good-bye Social Security." "When do you think it will end?" asks the wife. "The day I retire," says the man.

* *

LEE: If there is a genuine folk-hero anywhere in America, it is the man with the most fantastic acronym in history. Iacocca (I-A-C-O-C-C-A) turns into I-am-chairman-of-Chrysler-Corporation-of-America. Excerpts from Iacocca's new book appeared in last week's Newsweek. A few excerpts from the new book (due Nov. 1):

■ Iacocca calls Ford "a king who could tolerate no equals" and a "despot," and writes that "Henry Ford made my kids suffer, and for that I'll never forgive him."

■ After a Ford spokesman was quoted as saying Iacocca had been fired because "the son of an immigrant born in Allentown, Pa., is a long way from Grosse Point," Iacocca got a telephone call from a man offering to break Ford's arms and legs.

"No thanks," Iacocca writes that he said. "That's not really my style. If you guys did it, I wouldn't get any satisfaction out of it. If I'm going to get violent, I'd want to break his legs myself."

Iacocca also says that government has "too many lawyers and not enough people from business. I'd like to see a system where we brought in 20 top managers to run the business side of the country and maybe even paid them $1 million a year, tax-free.

"That would be a real incentive and then we'd see a lot more talented people interested in public life."

* *

An article in the Oct. 10 Christian Science Monitor provides lurid glimpses into the Soviet war against Afghanistan. But now the war is being directed with utter ruthlessness against civilians. This clip from the article tells a bit of the story:

> Soviet tactics are now aimed at totally destroying the civilian infrastructure — farms, houses, bazaars, mosques, schools, and clinics — in zones where resistance fronts have been particularly well-organized.
>
> "It does not take much to realize what the Russians are trying to do," added a spokesman of the Swedish Committee for Afghanistan in Peshawar, Pakistan, another organization involved in direct relief operations to the interior. "They are turning every region that does not bend to their will into a wasteland."

* *

Why is the dollar so strong? This is the most asked about question today. One answer was provided by former Treasurer Arthur Burns, as witness this quote from the Oct. 12 WSJ lead-off article:

> The "heart of Western Europe's problem," according to Mr. Burns, "is the welfare state." Even in Britain, he says, "all that (Prime Minister Margaret) Thatcher has been able to do is chip away a little at the margin. She has retained the essentials of the welfare state." As a consequence of "excessive" governmental handouts, he says, "people in Western Europe have come to regard the benefits of government as a God-given right; the result is an awful lot of voluntary unemployment and, ultimately, economic stagnation." He adds, "By comparison with Europe, we have a capitalist paradise in the U.S; it's no wonder the dollar is so strong."

* *

On September 28 the dollar lost 4% against the German mark. In came the Redman. The Redman is the traders' name for Russia, and don't think that just because the Russians are Communists they don't know how to trade. Through its banks, the Russians are reported to have made big profits on the sharp rise in the dollar. So when currency traders shout, "Redman coming in!" they aren't talking about a raid by apaches, they're talking about shrewd currency traders in the Soviet banks.

* *

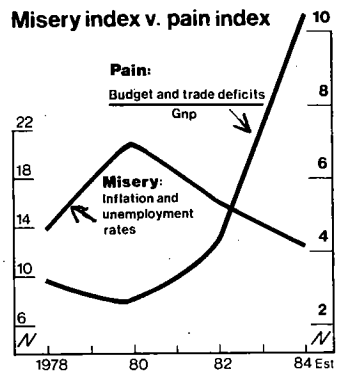
Some of the most intelligent economic and political comments appear in the Letters-to-the-Editor page of the London Economist. This letter from the September 29 issue caught my eye, and I thought it worth reprinting.

Pain index

SIR—Your discussion (September 15th) of Mr Mondale's plan and Mr Reagan's nonplan to control the outyear budgets fails to challenge their optimistic assumptions of steady growth. Unfortunately, the huge budget and trade deficit explosions, already recorded, seriously threaten these assumptions. Regardless of who wins the election and his future plans, the delayed impact of these current deficits will soon play havoc with the economy and create unforeseen misery.

To illustrate this point, I have developed a leading indicator which predicts the course of Mr Arthur Okun's clever "misery index" (see chart on next page). The "pain index" is easily computed from the sum of budget and trade deficits divided by gnp. It has increased almost fivefold since 1980, while misery, as the administration proudly emphasises, has been cut in half.

This interaction is logical, since budget deficits control unemployment by fiscal stimulus, and trade deficits control inflation through import competition. When both deficits are deliberately forced to record extremes by deep tax cuts and a seriously overvalued dollar, the result is today's declining unemployment and inflation. But how long can this improbable situation last?



The screams of excruciating pain from the financial and industrial sectors have finally alarmed Washington decision-makers. Bipartisan strategies to slash both deficits are nearing completion. When these programmes are implemented in 1985 the pain index will execute a reversal. Thereafter, the course of misery is self-evident.

Kings Point, New York HENRY FOGEL

* *

Occasionally I include a piece on California craziness, and I usually caption it "Only in California." But I give up. Africa is crazier than California, as witness this UPI news clip from last week's paper:

> NAIROBI, Kenya (UPI)—A three-foot lizard wandered into a Mombasa courtroom, touching off a stampede of spectators and police that allowed the escape of 20 suspected criminals awaiting trial, the Kenya News Agency said Tuesday.
>
> The monitor lizard received capital punishment for assisting in the Monday jailbreak. It was beaten to death with chairs and benches by court bailiffs, the news agency said.

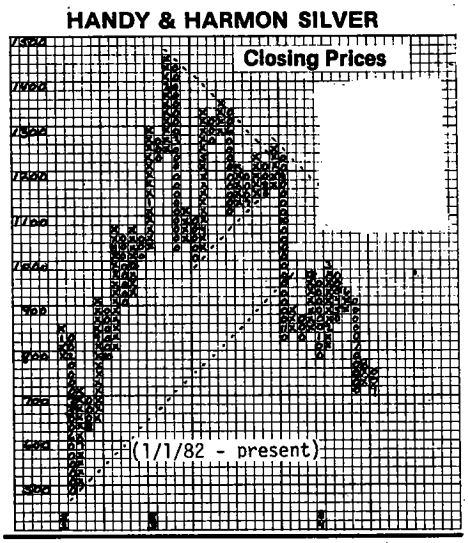
A friend just came back from South Africa (he is a former South African citizen) and told me that conditions there are just "terrible." He expects the prime rate to go to near 25% this week, said inflation is rampant. Said that the only thing S. Africa is exporting now is gold; also said there is extensive black unrest and rioting. The low gold prices and low production, he continued, is hitting SA very hard. Told me that friends of his in business are just shaking their heads.

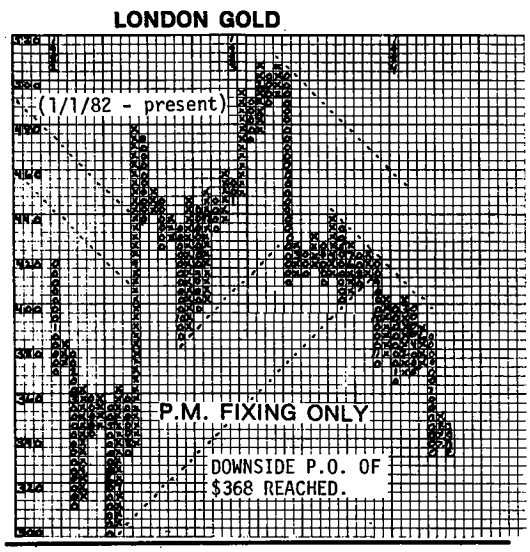
The reports I receive from Europe are not as bad but nevertheless dismal. Europe is trying to subsidize its dying industries but unemployment remains high. Europe has been dealing in welfare and transfer payments for four decades and the damage is now surfacing with a vengeance. You can almost sense it and see it for yourself. Go through a US department store and see how many European products you can count. The big export production has now shifted to Japan and Asia. Europe has fallen woefully behind on all fronts.

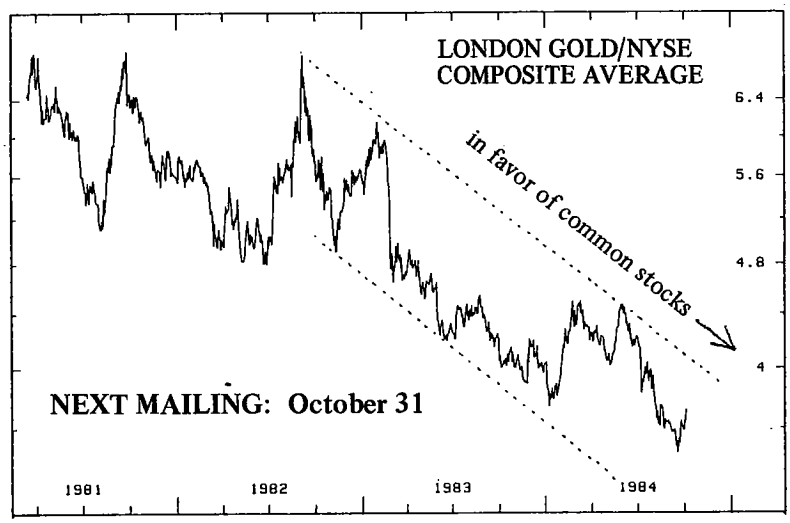
GOLD: The chart at the bottom right-hand column is the chart no gold-bug wants to look at (chart again courtesy of John Carder). It's a chart showing the ratio of gold to common stocks. We're actually looking at a relative strength chart of gold vs. common stocks, and as you can see, since mid-1982 the broad trend of relative strength has been towards common stocks and against gold.

One of these days this ratio is going to bust through the upper limits of the declining channel depicted here. That will constitute what I term a bullish background for gold. It hasn't happened yet, so my advice to goldphiles and silver hoarders and platinum stockpilers is, "Hold off. Your time has not yet come."

The point & figure chart of both gold and silver offer little in the way of encouragement. I probably read as much pro-inflation and pro-gold and silver literature as anyone in the nation. But as long as these two charts remain bearish, all that literature is simply an exercise in "dreams and wishes." The charts are courtesy of Chartcraft, Larchmont, NY.







TERRIER ELBOW?

I don't know how I did it but I have been fighting an infection on my left elbow for the past two weeks. I'm supposed to take it easy while I load up on anti-biotics. So I'm not going to drive myself crazy and fill up this letter down to the last white space. My elbow is getting better, and I hope by the next mailing I'll be OK (the infection would have to be in the left elbow–I'm left-handed).

Now that I think of it, maybe "pulling" with my English bull terrier did it. These are the strongest dogs (pound for pound) in the world, and mine loves nothing better than to get on the other end of a rubber "pull toy" and pull, pull, pull. If you've ever seen a bull terrier's grip, you'll know what I'm talking about. They'll pull your arm off before they let go. Is that what happened to my elbow? Anyone want to trade for a toy poodle?

LATE NOTES: The D-J Utility Average closed out the week ending Oct. 12 at a 1984 high of 140.75. The Utilities were joined by a strong bond market. In the face of the strong bond-utility action, the stock market found the path of least resistance to be up. The PTI closed the week (see page 2 chart) at 1611, only 6 points from its high for the year of 1617. And remember also that we have a definite downside non-confirmation on the part of the D-J Transports. They did NOT confirm the recent Industrial lows.

I know everybody has written the short interest off as a case of mass arbitrage, but now that nobody's looking at it -- I am. There are a record number of shorts sitting in this market, and my feeling is that if the PTI breaks out and the Averages start grinding upwards, we could see some interesting bullish action -- very interesting indeed. Moreover, my studies say that we're in a primary bull market. If so, then somewhere along the line we could see the short squeeze of the century.